



## Missouri Division of Finance

# UPDATE

### A Report of Missouri State Chartered Financial Institutions

Issue 01-1

April 2001

**From . . .**  
**Acting Commissioner**  
**D. Eric McClure**

Missouri's state chartered banks continue to be in good financial condition. Although we are seeing some signs of stress due to the uncertain economy, our banks, overall, remain well capitalized and profitable. We are proud of Missouri's banking system and especially of our community banks. The community banks are the financial backbone of many local economies, providing many services which are absolutely essential. The number of state chartered banks in Missouri is still very high relative to other states even though consolidation is ongoing in the industry. We have chartered almost 30 new state banks in the past ten years; just this month we chartered a new bank in Richmond, Missouri. I have recently had the pleasure of personally discussing issues regarding Missouri's banking system with various state leaders and have been assured that they recognize the value and importance of our community banks.

Many challenges face our industry, not the least of which is an uncertain economy. Almost without exception, when I have seen banks get into trouble, it was the result of certain lending decisions that failed to comply with the bank's own loan policy. The importance of maintaining a culture where the fundamental requirements of these policies are recognized and adhered to cannot be stressed too much.

We are in the preliminary stages of planning outreach meetings around the state this fall. Our intentions are to bring key members from the Division of Finance to both discuss current issues and to listen to your concerns and comments. We hope to foster easier and more open dialogue by holding smaller meetings at a number of locations around the state. We welcome your input regarding all aspects, from agenda items to proposed locations, as we plan these meetings.

#### GENERAL USURY

Section 408.030 provides that the Director of Finance shall declare the quarterly market rate of interest each quarter, post it in accordance with Section 361.110 and publish it in appropriate publications. Said quarterly market rate for the period April 1, 2001 through June 30, 2001 shall be 8.6%; as an alternative, 10% may be used.

#### *In This Issue:*

- G-L-B Privacy
- New Regulations
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- Missouri State Banking - Continuing Success
- Effects of Rescission

## EXAMINATION SURVEYS

The Division of Finance recently initiated a continuous customer feedback process. Following examinations of Missouri state chartered banks, savings and loan associations, and trust companies, we are mailing surveys to gather information from our "customers" with respect to the quality of our products and services. We value these opinions and hope that the surveys will be completed and returned at the earliest convenience. While we have performed similar surveys in the past, we have changed the method of distribution. Prior surveys were mailed *en masse* to all institutions. The current method is to survey institutions soon after we have examined them. Hopefully, this will be more effective in allowing communications about the examination. The input is valued and greatly appreciated.

To help facilitate the survey process, we have contracted with the Center for Advanced Social Research (CASR), at the University of Missouri-Columbia. Completed surveys will be returned to CASR, rather than to this office, to ensure anonymity. As always, customers are welcome to call this office if there are any particular concerns or questions with respect to our examination process or any other areas of our responsibility.

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## RECOGNITION

### APPLICATIONS

Corporate applications filed in Year 2000 remained steady with the largest number of filings being new branch applications. Sixty-three branches were authorized, 7 mergers, 4 charters and 2 conversions were approved and 16 main banking offices or branches were relocated. First quarter 2001 shows continued branching interest with 10 approvals in the first quarter.

Congratulations to the newest addition to the state banking system. **Community Bank of Missouri** was chartered April 17, 2001 and will be located at 201 East Franklin, Suite 1, Richmond, Missouri. Initial capital is \$3,000,000.

We would also like to recognize and honor those 52 state bank charters that have weathered the tide for over 100 years and remain active in our system. The **Bank of Holden** takes top honors with legal records showing it becoming a corporation 129 years ago!

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## INTERNET INFORMATION AVAILABLE FOR BANK CUSTOMERS

The FDIC has published a brochure aimed at informing consumers of their rights and responsibilities when banking over the Internet. "Tips for Safe Banking Over the Internet" was created in collaboration with the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. The brochure offers tips on how to confirm that an online bank is legitimate or verify its deposit insurance status, ways to maintain secure transactions online, and how to protect personal private information. Information is also provided on filing a complaint, finding information on consumer protection laws, and seeking assistance from banking regulators.

A bank can obtain a camera-ready copy of this brochure directly from the FDIC. Banks may then produce their own copies and place their bank name and logo on the back. The brochure is also available to read or download online at [www.fdic.gov/bank/individual/online/safe.html](http://www.fdic.gov/bank/individual/online/safe.html).

## CAUTION ON LOAN RISK

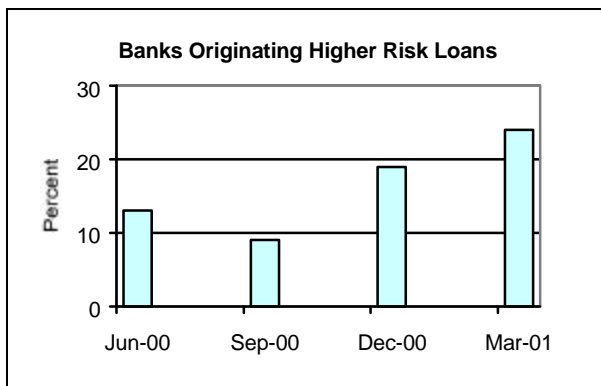


The Division of Finance has identified a modest rise in loan risk profiles for Missouri state chartered banks.

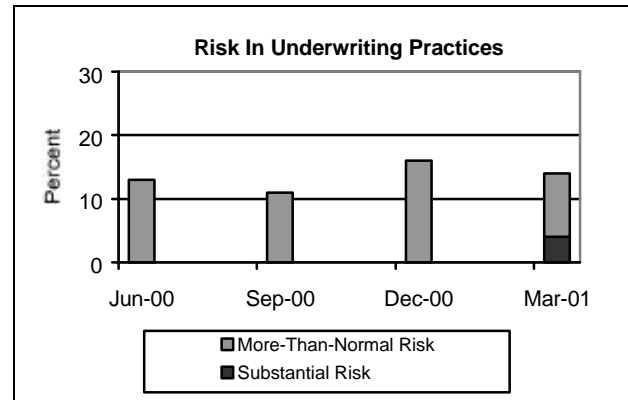
Data from our *Bank Examiner's Survey of Current Underwriting Practices* and past due trends are leading indicators of potential loan portfolio stress. Another signal is from bank examination results, a lagging indicator. In other words, by the time problems are listed in an examination report, the damage has already been done. The question is "how much damage?"

Individually, the survey results, past due figures, or classification ratios are not remarkable – but, when aggregated, concerns emerge that bankers may be relaxing lending standards to book new loans. This may spell future trouble when coupled with a slowing Missouri economy.

Survey Results: State examiners report their observations of current loan underwriting practices to the Division. We track their findings quarterly. While the sampling in any one quarter is inadequate to apply to the industry in general, several trends catch our attention.



The chart above depicts the percentage of banks examined in the quarter that have booked new loans containing "more than normal" risk - in the opinion of the examiner. The two-quarter increase in the ratio from 9 to 24 percent is noteworthy.

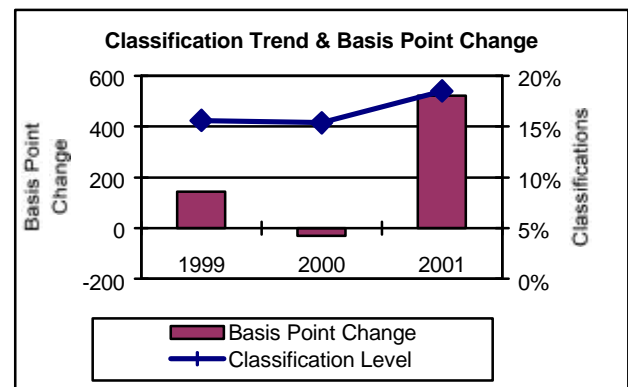


The above chart illustrates the examiners' opinion of the banks' loan underwriting in general. Although no significant change in general underwriting practices is evident, the most recent period ending in March found several banks incurred "substantial risk" in loan procedures.

Both responses indicate bankers may be stretching normal lending underwriting criteria. Examiners report collateral based lending, absence of cash flow evaluation, and liberal repayment terms as the primary factors inflating credit risk.

Past Due Loans: Loans past due 30 days or more equaled 1.82 percent of total loans December 1999 in state chartered banks. The ratio increased 43 basis points to 2.25 percent December 2000. March 2001 data is not available at the date of this printing.

Examination Results:



(continued)

## **CAUTION ON LOAN RISK (continued)**

The average ratio of classified assets to capital and reserves grew from 15.4 percent in 2000 to 18.5 percent for bank's examined thus far in 2001. Comparing each bank's classification ratio to that of the last examination, an average 520 basis point increase in the level of classifications is noted. The data shows moderate deterioration in loan quality. This decline, coupled with the indicators from current lending practices, suggest many banks will see an increased volume of troubled loans.

Summary: The combination of a slowing economy and liberal lending practices is a recipe for increased credit risk in the loan portfolio. Now might be a good time for bank managers to step back and take a hard look at current lending practices. How many loans were made last month in exception to the loan policy? Sound credit administration, particularly in regard to evaluating repayment capacity and collateral valuation, is vital to understanding and managing emerging risk. As part of internal loan review, we encourage bankers to "stress test" individual loans and portfolio segments to identify potential problems, instead of reacting to problems after they surface. We also emphasize the importance of maintaining adequate loan loss reserves. Past charge-off or past due history from the robust economic times may be very deceptive for indicating risk in the present portfolio and in the current economy.

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## **INTERNAL LOAN REVIEW**

Credit risk is the primary financial risk in most banks. Accurate and timely identification of developing problem loans is essential to managing credit risk. Bankers are encouraged to adopt an internal loan review system to isolate weaker credits as early as possible so that management can focus its attention on them. The loan review function may vary depending on the bank's size, complexity and management practices. The spectrum ranges from independent loan review departments in large institutions to relying solely on loan officers recognizing and drawing attention to emerging problems with loans they originate. Obviously the latter method is not ideal: checks and balances are needed.

Whatever the structure of the loan review system, management should ensure its effectiveness by incorporating the following elements:

- Prompt identification of weak loans.
- Consistent application of internal credit grades.
- Periodic review of all significant credit relationships to identify changes in risk profile.
- Providing management and the board with an objective and timely assessment of specific problem credits as well as the overall quality of the loan portfolio.
- Providing essential information to determine the adequacy of the Allowance for Loan and Lease Losses.
- Identifying exceptions to the loan policy and procedures.
- Assessing compliance with laws and regulations.
- Determining if relevant supporting loan documentation is obtained.

## Missouri State Banking - Continuing Success in the New Century

Missouri state chartered banks ended the year 2000 with continued strong growth and performance. At year-end 2000, 314 state chartered banks held \$38.9 billion in assets and \$32.3 billion in deposits. This is a strong increase from the previous year-end when 315 banks held \$34.7 billion and \$28.8 billion in assets and deposits, respectively. During 2000, only one bank left the state banking system. The remaining 314 banks grew 12.1 percent. This is quite favorable, especially since the industry's growth nationwide was 8.8 percent, while the state and national Gross Domestic Product grew an estimated 3.2 percent and 5.2 percent, respectively.

Return on assets for Missouri state banks in 2000 was considered to be solid at 1.10%, down slightly from the 1.15% posted in 1999. Net interest margins continue to tighten and loan loss provisions have increased.

Loan growth has again been strong but non-traditional sources of funding have supported part of this growth which has caused measurable increases in the ratio of loans to deposits.

As the economy cools, asset quality indicators are starting to show a slight deterioration. Nonperforming loans (loans past due 90 days or more or on nonaccrual) continue to be at relatively low levels, but an increasing trend is evident. At year-end, these loans represented 0.83% of total loans, compared to 0.67% one year ago. Nationally, this indicator is 1.12%.

Net charged off loans to total loans remained low and steady at 0.19% in 2000 (1999 and 1998 were 0.19% and 0.17%, respectively). The national charge off rate was 0.64% in 2000 and 0.63% in 1999.

Selected performance measurements of Missouri state chartered banks are depicted below:

Missouri State Banks		
	2000	1999
Yield on Earning Assets	7.87	7.89
Cost of Funding Earning Assets	3.98	3.75
Net Interest Margin	3.89	4.14
Credit Loss Provision to Average Assets	.23	.21
Return on Assets	1.10	1.15
Net Charge offs to Loans	.19	.19
Non performing Loans to Total Loans	.83	.67
Efficiency Ratio	58.99	58.43
Equity Capital Ratio	9.19	9.11
Loans to Deposits	83.69	81.94
Loans to Assets	69.41	68.07
Earning Assets to Total Assets	93.19	92.18

Missouri state chartered banks continue to be in excellent financial condition with very strong capital levels and solid earnings. In 2000 only nine state chartered banks (2.9%) were unprofitable (six of the nine were recently chartered).

The State Banking System is considered to be sound and is well prepared to face times of economic uncertainty.

## COMPLIANCE REVIEWS

During consumer reviews, the lender's collection and repossession procedures are reviewed for compliance with sections 408.551 to 408.562, RSMo, and UCC sections 400.9-501 to 400.9-507.

Bankers retain copies of all notices of right to cure, notices of sale, and notices of deficiency. This may become increasingly important should pursuit of a deficiency balance evolve into litigation where the burden of proof would be on the bank as creditor/plaintiff.

In cases of voluntary surrender, lenders should make every effort to obtain a signed surrender statement from the borrower. If this is not possible, thorough documentation is needed.

Examiners will also verify all fees associated with the repossession or court action. Recoverable fees must be necessary, bona fide and paid to third parties. The examination process may be streamlined by maintaining receipts in file.

In conclusion, documentation and record retention at each step of the collection/repossession process should ensure lenders a less invasive and time-consuming examination and protect against borrower claims in court actions.

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## POLITICAL SUBDIVISION LEASES

Cities often desire to develop municipal real property by leasing it to a third party, which leases it back to the city as the property is developed. Such transactions are structured to allow the city to enter into the transaction without becoming a borrower and, therefore, without exceeding constitutional debt restrictions. However, a problem arises if the third party lessee/lessor is a bank. The problem is that state law allows banks to lease real property only in limited circumstances that are not present in such lease arrangements. The unauthorized leasing of real property is an *ultra vires* act for the bank, which would be a violation of law. Alternatives for avoiding such a violation include:

- The bank establishing a real estate development corporation subsidiary, following the limit and notification requirements in Division of Finance Regulation 4 CSR 140-2.065, to hold and lease the property instead of the bank directly (this arrangement would be subject to FDIC approval);
- Structuring the arrangement to utilize as a borrower an instrumentality not subject to the municipal debt limits, which would lease the real property from and back to the city and obtain a loan from the bank for the development; or
- Structuring the arrangement to utilize an instrumentality to lease the property from and back to the city and then assign the rights to the stream of payments under the lease to the bank. The bank would not be lessor or lessee. The bank would provide a payment for the assignment of rights, rather than a loan. This bank payment would substitute for loan funds, and the city's lease payment that is assigned to the bank would substitute for loan payments.

If the lease with the city is for more than one year, it may be voidable by law. Therefore, as a safety and soundness precaution, the Division requires the debt investments in these arrangements (including a payment for assignment of loan payment rights) to be limited to the bank's legal loan limit, even if the borrower is a political subdivision.

## **NEW REGULATIONS**

The Division of Finance has issued two financial modernization regulations which should be effective by August 30, 2001. One of the regulations provides procedural guidance to assist banks in establishing a "financial subsidiary" to engage in activities such as insurance sales, securities sales and securities underwriting. Financial subsidiaries were authorized for national banks under the Gramm-Leach-Bliley Financial Modernization Act of 1999 and were authorized for Missouri state banks in 2000. The new financial subsidiary regulation also advises Missouri banks of the legal restrictions and limitations on establishment of financial subsidiaries. The other modernization regulation authorizes Missouri banks and trust companies to establish trust representative offices, which are offices for sales and marketing purposes that do not constitute branches of the institution. The bank or trust company employees at the trust representative office can engage in any sort of sales or marketing activities on behalf of the institution, but cannot engage in the core fiduciary activities of accepting fiduciary appointments, executing documents that create a fiduciary relationship or making decisions regarding the investment or distribution of fiduciary assets.

## **SETTLEMENT STATEMENTS**

It is the rare compliance examination that fails to cite exceptions concerning completion of settlement statements.

In years past, many banks regularly failed to disclose premiums for hazard insurance. It was also common for banks to erroneously disclose the amount of coverage rather than the premium for title insurance.

Lenders have now become more familiar with these disclosure requirements, but it is increasingly common to see failures to disclose the previous year's property taxes on non-purchase transactions.

Line item instructions for completion of the HUD-1 and HUD 1A forms are included in Appendix A of RESPA. These instructions can be useful as they briefly describe of most items being disclosed and assist in determining the type of fee and its proper placement.

Employees involved in loan processing should be familiar with these instructions. A knowledgeable staff will be able to review settlement statements prepared by title companies or attorneys. Such employees should remember that these same instructions apply to the line item disclosures included on the good faith estimates.

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## **DEPOSITING INSURANCE PREMIUMS**

The Missouri Department of Insurance advises us that premiums coming into a bank-owned insurance agency must go into the agency account, not the bank's general account. Otherwise, the agent or agency could be deemed to have misappropriated funds. Also, under Sections 375.051 (agents) and 375.121 (brokers), the respective licensees must hold funds in a fiduciary capacity. The Department of Insurance must be able to ascertain where insurance premium funds are when they investigate a complaint of misappropriation.

## **LISTS REQUIRED TO BE SUBMITTED TO THE BOARD OF DIRECTORS UNDER SECTION 362.275**

Section 362.275 requires that certain lists of loans and indebtedness be submitted to the board of directors of the bank or trust company. Neither the first list, which calls for the aggregate of loans, discounts, acceptances and advances over a certain amount, nor the second list, which requires a listing of each borrower's aggregate indebtedness (over a certain amount), require the inclusion of unfunded amounts of lines of credit.

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## **LEGAL LOAN LIMIT**

For legal loan limit purposes, "unimpaired capital" in Section 362.170 includes intangible assets. Total capital is taken directly from the call report, which does not exclude intangibles. To determine your appropriate legal loan limit threshold under Section 362.170 RSMo, you should take your total unimpaired capital, including the intangibles, and multiply it by the appropriate percentage based on the population of your main office's location. However, the Division of Finance cautions all banks to consider principles of diversification of assets and to be wary of the excessive concentrations of credit that can create undue risk to the bank. In other words, if the bank's intangibles have recently increased substantially, we would consider it an unsafe and unsound practice to automatically reach your new legal lending limit threshold without considering the overall effects on the institution.

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## **RESEARCH AND PLANNING WEB SITE**

([www.ded.state.mo.us/research/](http://www.ded.state.mo.us/research/))

We believe this Web site could be very useful to bankers analyzing their local economies. The goal of the Research and Planning office (RAP) of the Department of Economic Development is to provide the state's decision-makers and citizens alike with the most accurate and up-to-date information concerning Missouri's diverse and vibrant economy.

To facilitate access to this information, RAP posts all of its work products to the office's site on the World Wide Web ([www.ded.state.mo.us/reasearch/](http://www.ded.state.mo.us/reasearch/)). Standard economic indicators (unemployment, cost of living, purchasing managers' index), economic impact studies and economic sector analyses are all presented in easy to find and understand formats. Most of the studies include state-of-the-art Geographic Information Services (GIS) mapping support, giving users the opportunity to see how the information relates to their county or region of the state. The site also includes RAP's interactive mapping system.

Through the RAP Web site, legislators, state officials, economic developers, bankers, business leaders and the public at large have the best economic information available on which to base the important economic decisions of the state.

## EXPEDITED BOARD ACTIONS

Banks may at times have emergencies or time sensitive issues arise that require immediate action by the board of directors. Normally, a board meeting can be called right away. However, there are times when an actual board meeting is either impossible or tremendously impractical. In such cases, banks may use any of the following alternatives for taking board action:

1. The board may meet by telephonic conference call under Section 362.247 RSMo, provided that the bank has a 1 or 2 composite CAMELS rating and that the meeting will not be attended by state or federal regulators. Other requirements are listed in Section 362.247.
2. The directors can all sign a unanimous consent for board action, waiving any notice requirements, which takes the place of a physical meeting. This consent can be faxed to the various directors, who can sign and return fax the signed consent to be routed to the next director until all have signed. This process for board action is authorized under Sections 351.690 RSMo and 351.340 RSMo, which lists the administrative requirements. All directors must sign this consent for it to be effective.
3. If the bank has created an executive committee of two or more directors pursuant to authorization in its bylaws, the executive committee can meet to take action and, under Section 362.253 RSMo, has the power to “exercise all of the authority of the board of directors in the management of the bank.” An executive committee meeting would be proper for many operational issues, but would not be acceptable for meetings regarding regulatory enforcement actions. The board chairman should use discretion in choosing this option, as it may eliminate participation by several board members.
4. The bank’s senior officers may take a poll of the directors on “any issue in need of immediate action and ultimate board approval” under Section 362.275.2 RSMo. The poll must obtain the number of votes required for the action, but must also be subsequently ratified by the board. Because of the ratification requirement, any action taken using such a poll should be taken subject to approval of the board in a duly authorized telephonic or physical meeting or by unanimous consent. Therefore, the polling method should not be used to commit the bank to legal obligations unconditionally because of the chance that the required ratification would fail, resulting in the bank’s action being unauthorized and *ultra vires*.

**Division of Finance  
Field Offices**

<u><b>District</b></u>	<u><b>Location</b></u>	<u><b>Telephone</b></u>
Kansas City	Suite 200 310 Northwest Englewood Gladstone, Missouri 64118 Mail: Same (Consumer Credit)	(816) 467-7991 (816) 467-7992 (816) 467-7993 (Trust) (816) 467-7997 (Fax) (816) 467-7994
Central MO	3610 Buttonwood Drive (65201) Mail: P.O. Box 638 Columbia, Missouri 65205	(573) 884-6454 (573) 884-1426 (Fax)
St. Louis	815 Charter Commons Drive, Suite 2 Chesterfield, Missouri 63017 Mail: Same (Consumer Credit) (Trust)	(636) 207-8011 (636) 207-8013 (Fax)  (636) 207-8016 (636) 207-8015
Springfield	1410 S. Kansas Expressway (65807) Mail: P.O. Box 10287 Glenstone Station Springfield, Missouri 65808 (Consumer Credit)	(417) 895-7545 (417) 895-7546 (417) 895-7547 (Fax)  (417) 895-6607
Southeast MO	203 North New Madrid Street Mail: P.O. Box 747 Sikeston, Missouri 63801	(573) 472-5266 (573) 472-5267 (573) 472-6673 (Fax)

## G-L-B PRIVACY

The deadline is July 1, 2001, for banks, trust companies and savings associations to comply with the privacy requirements of the Gramm-Leach-Bliley Financial Modernization Act of 1999 ("G-L-B").

Generally, under G-L-B:

- Financial institutions must establish a privacy policy regarding sharing of nonpublic financial information of consumers and customers and distribute a notice of the policy to all customers and consumers doing business with the institution.
- Examples of nonpublic financial information are: (a) the fact that an individual is a customer, (b) application information provided by a customer, and (c) information on a consumer report obtained by the financial institution.
- The notice must be distributed initially to all existing customers and, in the future, before an individual customer relationship is established. Also, all institutions must send out an annual notice to customers and a notice upon any revision to the policy. Consumers, who are people doing business with the institution in only an isolated transaction, must get the notice prior to sharing of their information.
- Financial institutions must allow customers and consumers to "opt-out" of financial information sharing with unaffiliated third parties prior to any such sharing occurring. However, unless the individual submits a specific choice to "opt-out," the institution is not prohibited by G-L-B from sharing information with unaffiliated third parties.
- Financial institutions must refrain from sharing customer account numbers with unaffiliated third parties.

The limits of G-L-B do not apply to disclosure of financial information to affiliated companies. (However, the Fair Credit Reporting Act may require the institution to offer an opt-out to consumers and customers for certain disclosures to affiliated companies in order for the institution to avoid being subject to consumer reporting agency regulations.)

Pending state legislation may set a later compliance deadline for insurance companies, but this will not affect the federally mandated July 1, 2001, deadline for banks, trust companies and savings associations.

G-L-B's privacy provisions are somewhat complicated and include a variety of exceptions and other requirements not listed here. This summary highlights just some of the major points. You should consult the regulations and statute to address any specific questions.

G-L-B's privacy requirements will not prohibit banks from responding to inquiries about the availability of funds for accepted checks, because such inquiries are "necessary to effect, administer, or enforce a transaction that a consumer requests or authorizes in connection with . . . servicing or processing a financial product or service that a consumer requests or authorizes." Inquiries seeking to verify funds availability or to obtain loan payoff information fall within this exemption.

## **EFFECTS OF RESCISSION OF A RESIDENTIAL REAL ESTATE LOAN**

We are frequently asked about the effects of a rescission of a residential real estate secured loan. We refer the lender to Regulation Z section 226.23(d) which provides the answer: ". . . the consumer shall not be liable for any amount . . . ." This suggests that the bank may be responsible for amounts paid by the now-rescinded borrower even though the bank did not get the money e.g. the costs of a credit report or an appraisal which was duly ordered and paid for by the bank. That is correct, hard as it may be to believe. The Official Staff Commentary makes it clear that the bank may be obliged to 'refund' to the now-rescinded borrower some funds which the bank does not have any more e.g. the cost of a bought and paid for appraisal. The Commentary states: "The consumer cannot be required to pay any amount . . . to the creditor or a third party as part of the credit transaction. Any amounts . . . already paid . . . must be refunded. 'Any amount' includes finance charges already accrued, as well as other charges, such as broker fees, application and commitment fees, or fees for a title search or appraisal, whether paid to the creditor, paid directly to a third party, or passed on from the creditor to the third party. It is irrelevant that these amounts may not represent profit to the creditor."

## **WANTED: Your Ideas, Suggestions and Observations**

We constantly strive to improve the UPDATE. Listening to our readers' suggestions is one way to do this. If you have any comments or suggestions, please contact the Division of Finance at the following addresses or numbers:

<http://www.missouri-finance.org>

or e-mail us at:

[finance@mail.state.mo.us](mailto:finance@mail.state.mo.us)

(573) 751-3242

(573) 751-9192 (Fax)